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DEPARTMENT OF LAW OPINION NO. 74-19 (R-40)

REQUESTED BY: CLAUDE D. KELLER
Director of Securities
Arizona Corporation Commission

QUESTION: Where a corporation engaged in land development issues fifteen corporate promissory notes of one, three and five year maturities over a one year period to individual investors ("lenders"), and in connection with each issuance also collaterally assigns notes and mortgages on separate lots to such investors, do the registration and related provisions of the Real Property Securities Dealers Act apply to these transactions?

ANSWER: Yes.

The Real Property Securities Dealers Act (A.R.S. §§ 44-2066, et seq.) was enacted by the Arizona Legislature during the 1973 regular session, and became effective as law on August 8, 1973. The Legislature was concerned that existing statutes relating to securities did not adequately regulate the distribution of real estate mortgages and trust deeds to the public. Certain persons or corporations directly or indirectly (e.g., by securing corporate promissory notes) had been distributing or marketing mortgages or trust deeds to individuals for investment, and had been using the funds generated to capitalize or operate various enterprises. In the course of the distribution of these documents to investors, certain inequitable practices developed; for example:

1. Investors were provided with inadequate or inaccurate information concerning the value of the underlying real estate and the credit standing of the real estate purchasers.

2. Misleading claims with regard to the value or safety of the mortgages and trust deeds were made to investors.

3. Certain undercapitalized or improperly managed firms entered the field and were distributing these mortgages and trust deeds in at least a reckless manner, with little concern for validity of the documents.

The Real Property Securities Dealers Act (Act) was intended to eliminate or curtail these inequitable practices by requiring:

A. Registration of the persons selling and the documents being sold to the public.

B. Advertising standards and filing procedures.

C. Detailed reports and bonds.

It is well established that the coverage of the Arizona Securities Act (A.R.S. §§ 44-1801, et seq.) is considered quite broad. Jackson v. Robertson, 90 Ariz. 405, 368 P.2d 645 (1962); Reilly v. Clyne, 27 Ariz. 432, 234 P. 35 (1925), and that federal and state securities laws generally are considered broad in scope, applying to a wide range of investment schemes. Securities and Exchange Commission v. W. J. Howey Company, 328 U.S. 293, 66 S.Ct. 1100 (1946); Tcherepnin v. Knight, 389 U.S. 332, 88 S.Ct. 548 (1967); Securities and Exchange Commission v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir. 1973), cert. den. 414 U.S. 821; El Khadem v. Equity Securities Corporation, 494 F.2d 1224 (9th Cir. 1974); Silver Hills Country Club v. Sobieski, 55 Cal.2d 811, 361 P.2d 906 (1961); State v. Hawaii Market Center, Inc., 485 P.2d 105 (1971). Nevertheless, the Leigslature has clearly indicated by passage of this Act that significant broadening and tightening of regulation with respect to real estate securities and related investment devices was highly desirable public policy in Arizona.

With this background in mind, and pursuant to the following analysis of relevant law, it is our opinion that the fact situation described in your question does fall within the registration and other provisions of the Act. Conversely, if the corporate notes presently are being issued in the manner you describe and the provisions of the Act have not been complied with, then the resulting serious violations would mandate strong sanctions, including cease and desist action, injunctive action and/or criminal prosecution. A.R.S. §§ 44-2032 and 44-2036.

A.R.S. § 44-2066.03 provides that a person shall not act as a real property securities dealer without a permit. A.R.S. § 44-2066.08 provides that real property securities shall not

be sold to the public without a permit. A.R.S. § 44-2066.2(a) defines "real property securities dealer" as any person who engages in the business of selling real property securities. The heart of this analysis is what constitutes a "real property security".

Three definitions of real property security are provided by A.R.S. § 44-2066.3. One of the definitions will be discussed in this opinion. Subsection (b) of that section defines real property security as a series of promotional notes secured by liens on separate parcels of real property. "Promotional notes" are defined in A.R.S. §§ 44-2066.1 as promissory notes secured by mortgages or deeds of trust on unimproved and, in designated situations, on improved real property (e.g., when the mortgage or deed of trust finances the first purchase of the improved parcel). Another pertinent provision, A.R.S. § 44-2066.4, defines "sale" as including every issuance, disposition, attempt to dispose or exchange.

The previous discussion indicates the following test of whether certain transactions are within the scope of the registration and other provisions of the Act:

A. Actual or attempted sale, issuance, disposition or exchange.

B. Series of promissory notes.

C. Secured by mortgages or deeds of trust.

D. On unimproved or, in specified instances, improved parcels.

Little discussion is required regarding whether the first element of the above test is met by the presented fact situation. There is no doubt when authorized corporate officers execute general evidences of indebtedness of the corporation (e.g., bonds, notes, debentures) and cause them to be delivered to individuals in exchange for investment capital for the corporation that a sale, issuance or other disposition of that corporate obligation has occurred. See Securities and Exchange Commission v. National Bankers Life Insurance Company, 324 F.Supp. 189 (1971), aff'd, 448 F.2d 652.

With regard to the second element, as to whether these promissory notes are in series, it is necessary to refer to other sources, since the term "series" is not defined in the

Act. In Tarsia v. Nick's Laundry & Linen Supply Co., 239 Or. 562, 399 P.2d 28 (1965), the Oregon Supreme Court defined series as ". . . a group of usually three or more things or events standing or succeeding in order and having like relationship with each other." Webster's New World Dictionary indicates that the term "series" applies to a number of similar, more or less related things following one another in time.

In the presented facts, the corporation issued fifteen promissory notes of various maturities over a period of time to fifteen separate investors. It appears the notes were issued on various dates, thereby resulting in some pattern of succession. The notes were similar and more or less related, since supporting documents indicate they all were:

A. Issued by the same entity.

B. Secured by similar mortgages on small land parcels.

C. Drafted and organized in similar form.

D. Drafted using common major provisions (e.g., interest only installments).

Therefore, it is clear that these fifteen transactions were in series.

The third element of this test requires that the promissory notes be "secured" by mortgages or deeds of trust. It must be pointed out that the Act does not specify that the mortgages or deeds of trust directly secure these notes, which we interpret to mean that when these notes are secured by mortgages or deeds of trust in any manner recognized or permitted by Arizona law, then the "secured" requirement of the Act is met. "Secured" is not defined by the Act, but the Uniform Commercial Code (UCC), as enacted in Arizona (A.R.S. §§ 44-2201, et seq.), contains a number of provisions which are helpful in determining the scope of this term.

The threshold question before using that body of law is whether it has any applicability to promissory notes in some manner secured by real estate mortgages. It is clear that mortgages serving only as liens on real estate would be outside the scope of the UCC. A.R.S. § 44-3104.10. However,

in the case of mortgages being used as security for promissory notes, the UCC does have application. A.R.S. § 44-3102.C. This interpretation is borne out by Comment 4 of Section 9-102 (i.e., A.R.S. § 44-3102.C) of the 1962 Official Text of the Uniform Commercial Code, which provides the following example:

> The owner of Blackacre borrows $10,000 from his neighbor, and secures his note by a mortgage on Blackacre. This Article is not applicable to the creation of the real estate mortgage. However, when the mortgagee in turn pledges this note and mortgage to secure his own obligation to X, this Article is applicable to the security interest thus created in the note and the mortgage. (Emphasis added.)

See Riebe v. Budget Financial Corporation, 70 Cal.Rptr. 654 (1968).

A.R.S. § 44-2208.37 defines "security interest" as an interest in personal property (e.g., mortgage documents) which secures payment or performance of an obligation. "Secured creditor" has been defined as "one who holds some special pecuniary assurance of payment of his debt, such as a mortgage or lien". In Re New York Title & Mortgage Co., 289 N.Y.S. 771, 160 Misc. 67 (1936). A.R.S. § 44-3102.A.1 indicates that a secured transaction will be found in any transaction, regardless of its form, which is intended to create a security interest in personal property including general intangibles. Various courts consistently have held intent, and not form, to be the principal test of whether a "secured" transaction exists. In Re Joseph Kanner Hat Co., Inc., 482 F.2d 937 (2nd Cir. 1973); Bloom v. Hilty, 210 Pa. Super. 255, 232 A.2d 26 (1967), rev'd on other grounds, 427 Pa. 463, 234 A.2d 860; Bruce Lincoln-Mercury, Inc. v. Universal CIT Credit Corp., 325 F.2d 2 (3rd Cir. 1963).

Furthermore, the UCC makes no distinction in the various methods of creating security interests. For example, assignment, pledge, title retention contract or other security agreements are equally effective methods. A.R.S. § 44-3102.B. For similar reasons, it is not necessary to determine whether the collateral assignment of notes and mortgages concurrent with the issuance of the corporate notes in the presented fact situation constituted a pledge or other security agreement, or whether such notes and mortgages directly, indirectly

or collaterally secured the corporate notes. The critical question is whether the corporate notes were secured in some legally recognized or permitted manner. As mentioned, under the UCC and court interpretations, if the parties intend to create a "secured" transaction, then, regardless of the form or names used, the existence of a "secured" transaction/ "security" interest will be recognized. Underlying documents to your question indicate that "intent" was present:

1. The collateral assignment documents would not permit the corporate note holders to sell, pledge or otherwise dispose of the assigned notes and mortgages, tending to show that, rather than true ownership interest, the assignments only conveyed some type of security interest in the notes and mortgages.

2. The corporate notes indicate that a secured interest arrangement was contemplated (i.e., "This Note is secured by a Collateral Assignment of Notes and Mortgages").

3. The foreseeable or likely reliance on the mortgages as significant collateral by individuals receiving the corporate notes.

4. UCC-1 forms were filed in several instances covering contract rights as secured collateral, apparently including the mortgage contract rights.

5. The collateral assignment documents indicate certain rights in the underlying notes and mortgages were transferred to the corporate note holders concurrent with the execution of the corporate notes, indicating some type of pecuniary assurance backing up the corporate notes (e.g., possibly a pledge arrangement).

As stated the UCC "intent" test is met, and therefore the collateral assignment of notes and mortgages "secured" those mortgages to the corporate promissory notes.

Underlying documents submitted with this question indicate the real estate mortgages involved in these transactions were executed on separate parcels of real property sold to various members of the public in Arizona and throughout the United States (the parcels apparently were all located within one development), which satisfies the fourth element of the above mentioned test.

The remaining element deals with whether the parcels sold to the public were unimproved parcels or improved parcels financed in a manner within the Act. Apparently, many of the parcels have no construction in progress or structures, and consist of the land in its original natural state. In other words, the parcels are unimproved and, therefore, comply with the last element. Even in instances where the lots contain improvements, if they are sold subject to mortgage on first sale to consumers, those mortgages would be within the scope of the Act. A.R.S. § 44-2066.1.

Since all elements of the preceding test have been met, any persons issuing or otherwise disposing of the corporate promissory notes mentioned in your question in the manner described therein would be considered as selling real property securities and acting as real property securities dealers, and therefore subject to the Act.

Respectfully submitted,

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The Attorney General

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